Too Big to Fail

Teacher Instructions

This resource attempts to briefly inform students about the market failure in the banking system that helped bring about the global financial crisis. The article covers the events of Lehman brothers and the subsequent government actions to prevent other banks from failing around the globe.

It then looks at the reforms to banking and the possible new, global legislation for 2019 proposed by the Financial Stability Board at the Bank of England. The legislation is hoped to prevent another financial crisis from occurring in the future, but is much resisted by the banks themselves.

Finally the material considers the question of whether the investment arm of banks should be separated from the commercial arm to prevent systemic risk.

Students are invited to discuss a number of issues concerning the regulation of banking through a number of questions at the end of the resource.
During the economic success years between 1992 and 2008, we had continual positive growth and assets (particularly housing and shares) had grown in value. The banks were keen to lend to individuals and business because it was felt that the party wouldn’t end, that asset prices would continue to rise and the banks would get their money back, plus interest. The banks were lending far, far more than they should, and to customers with dodgy credit histories and employment records that were unlikely to be able to repay the loans (the ‘subprime’ market).

In September 2008, Lehman Brothers (a huge global financial institution, 158 years old) posted enormous losses due to the ‘toxic debt’ and the CEO began frantically selling off assets, but filed for bankruptcy on 15th September 2008. Other institutions that had loaned Lehman money then had their loans wiped out. The financial crisis entered a new and more dangerous phase after Lehman filed for bankruptcy and immediate lesson that many policy makers drew - and this is contested - was that it should have been rescued.

The Bank of England and the European Central Bank and decided that other big financial firms would not fail and billions of taxpayers’ money was thrown at the banks around the world. Three days after the bankruptcy, the US Federal Reserve, the Bank of England, the ECB and the Bank of Japan doused the global banking system with over £100 bn with the aim of trying to restart lending between banks. This was the start of using taxpayers’ money – it ended up costing the UK taxpayer many hundreds of billions to bail out the banks and stabilise the system again. Meanwhile share prices were crashing all over the world.

Individuals began to fear that their bank would fail, and began extracting their deposits causing a ‘run on the bank’. By the end of September, the British Government ringfenced individual savers’ deposits up to £50,000 (now £85,000) to reassure customers. However the bailouts were seen as deeply unfair – helping out banks when they had clearly been in the wrong. If a business was in the same position, it would just go bankrupt, but the banks were ‘too big to fail’. As it is, generations of tax payers will suffer as a result, whilst shareholders and creditors (lenders) to banks enjoyed the good times and were bailed out when things went wrong. At its peak in the UK alone, taxpayers’ direct subsidy to banks stood at more than £1 trillion according to a recent report from the National Audit Office, but justified this in order to head off the potential damage of the banks going bust.

Thus it was decided that it would be far better to change the rules of finance to ensure that any bank could safely fail if it gets into serious difficulty no matter how big it is.
GOVERNMENT INTERVENTION

World leaders approached Mark Carney, the Governor of the Bank of England and the Financial Stability Board for proposals that should come into effect in 2019 around the world which mean that taxpayers would not bear the brunt of such misconduct in the future.

Mr Carney explained that the new system would ensure that bank shareholders, and lenders to banks such as bondholders, would become first in line to bear the brunt of future losses if banks could not pay out of their own resources. “Instead of having the public, governments, [and] the taxpayer rescue banks when things go wrong; the creditors of banks, the big institutions that hold the banks' debt - not the depositors - will become the new shareholders of banks if banks make mistakes.”

The proposed new rules, which are up for consultation and should take effect in 2019, require “global systemically important banks” to hold a minimum amount of cash to ensure they will be able to survive big losses without turning to governments for help.

The capital set aside should be worth 15-20% of the bank’s assets, the FSB said. That is a far bigger cushion against losses than is required by current banking rules. The FSB hopes this stronger policy will prevent taxpayers from being forced to pay billions of pounds again to stop big banks from collapsing, in the event of another financial crisis.

Anthony Browne of the British Bankers’ Association welcomed the proposals. “The banking industry strongly supports this work, which is a really important step in ending ‘too big to fail’ and ensuring that never again will taxpayers have to step in to bail out banks,” he said.

“We agree with the aims and objectives of the proposals for total loss absorbing capacity (‘TLAC’), that there should be sufficient resources available to absorb losses in the event of bank failure and provide new capital to ensure critical economic functions can continue to be provided,” he added.

“Agreement on proposals for a common international standard on total loss-absorbing capacity for [big banks] is a watershed in ending ‘too big to fail’ for banks,” said Mr Carney.

“Once implemented, these agreements will play important roles in enabling globally systemic banks to be resolved without recourse to public subsidy and without disruption to the wider financial system.”
According to the BBC's business editor Kamal Ahmed, analysts estimate the new capital requirements could cost €200bn (£157bn) for Europe's banks alone, with the cost for globally significant banks in the US, Japan and China likely to be much higher. The FSB has published a list of 30 banks it regards as "systemically important", meaning their collapse could have a wider impact on global financial systems. In the UK, the banks are Barclays, Standard Chartered, HSBC and the Royal Bank of Scotland.

SHOULD THE COMMERCIAL AND INVESTMENT ACTIVITIES OF BANKS BE SEPARATED?
In 1933 in the USA, legislation was passed known as the Glass-Steagall Act, which put a firewall between traditional banking and more risky financial activities. Many people have argued that the Act's repeal in 1999 contributed to the financial crisis that engulfed the US.

Many people call for a new legislation that does separate out the casino-style investment banking from the high street, commercial banking that is undertaken for the majority of individuals. This would avoid what is known as 'systemic risk' in the banking sector – the fear that a mistake, or series of mistakes, by a bank will result in failure.
1. Why is it important to ringfence individual’s savings held in banks?

2. Why do the new regulations affecting banks need to be global?

3. Should banks be allowed to fail? Who should carry the loss?

4. Discuss the arguments for and against a separation of the investment side of banking from the commercial side of banking.